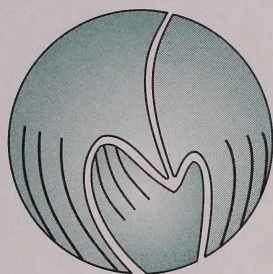


AL-2-1994-242
c-2

\$8

CANADIAN
SEP 20 199



BUSINESS ARRANGEMENTS

•
•
•

*Making the
best choice for
your farm*

BUSINESS ARRANGEMENTS

•
•
•

*Making the
best choice
for your farm*

Farm Business Management Branch
Alberta Agriculture, Food and Rural Development

Disclaimer

The purpose of this publication is to provide information that will help families discuss the alternatives available for operating a farm business. It is not intended for any other purpose. While every effort has been made to ensure the information in the publication is correct at the time of printing, neither the Crown, its agents or employees, nor the authors of this publication, assume any responsibility or liability whatsoever for any financial loss or damage suffered as a result of the publication or use of these materials, or as a result of any changes in the law after publication of these materials.

It is recommended that the services of professionals such as lawyers, accountants, insurance agents, etc. be sought in dealing with specific issues.

Published by:

Alberta Agriculture, Food and Rural Development
Publishing Branch
7000 - 113 Street, Edmonton, Alberta
Canada T6H 5T6

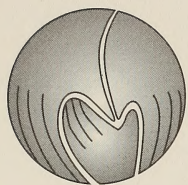
Editor: Gerard Vaillancourt
Graphic Designer: Wendy Luedtke
Typographer: Sherrill Strauss

Copyright © 1994. All rights reserved by her Majesty the Queen in the right of Alberta.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical photocopying, recording, or otherwise without written permission from the Publishing Branch, Alberta Agriculture, Food and Rural Development.

ISBN 0-7732-6118-4

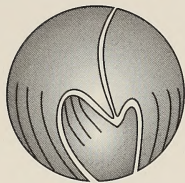
Printed July 1994



CONTENTS

PREFACE	v
INTRODUCTION	1
MANAGEMENT ISSUES	5
Profitable, Affordable And Desirable	6
Operating The Business	7
• Farm Business Continuity	
• Common Business Or Separate	
• Pooling Of Resources	
• Operating Specific Enterprises	
Owning The Business Assets	10
• Assets To Keep Within The Business	
• Assets Transferred To The Business	
• How The Business Is Owned	
• Housing Within The Business	
• Taxation Under A Business Arrangement	
• Cost Of Establishing The Arrangement	
LEGAL ISSUES.....	17
Capital Structure	18
• Who Owns The Farm Assets	
• Growth In The Business	
• Fixed Business Value	
• Voting Rights	
• Assets Rented Or Leased To The Business	
Rights And Obligations Of Business Owners	22
• Decision Making	
• Liability Within The Business	
FINANCIAL ISSUES.....	25
Investments In The Business	26
Financing Within The Business	27
• Equity Financing	
• Debt Financing	
Financial Control Within The Business	30
• Profit And Losses Within The Business	
• Money Taken Out Of The Business	

TAXATION ISSUES	33
Taxation Of Income	34
• Active Business Income	
• Investment Income	
Taxation Of Assets Transferred Into The Business	38
• Transferring Principle Residence	
• Transferring Liabilities Into The Business	
Taxation Of Family Members Who Are Active In A Business	40
• A Spouse Or Children As Employees	
• Spouse And Children In The Business	
Goods And Services Tax	42
CONCLUSION	43



PREFACE

Most farm businesses are owned, managed and operated by families. While this adds a degree of continuity and stability to the operation, most of them will be owned and operated for a number of years jointly by two or more generations. This common ownership and operation of the business with its eventual transfer to the younger generation gives rise to the need for a sound business arrangement.

This publication has been prepared to provide a basic understanding of the implications of corporate, partnership and joint venture forms of arrangements. Income tax and financial considerations are also presented because they are important when considering any business arrangement.

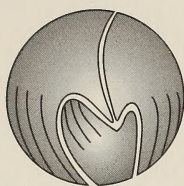
The material was written by Garry Bradshaw, Management Specialist, with the assistance of Merle Good, Provincial Tax Specialist, and Paul Gervais, Agricultural Economist, all with Alberta Agriculture, Food and Rural Development.

Dr. Glen Mumey, Head, Department of Finance and Management Science and Dr. Len Bauer Professor, Rural Economy of the University of Alberta provided valuable insight to the overall direction of the publication.



Digitized by the Internet Archive
in 2015

<https://archive.org/details/businessarrangem00albe>



INTRODUCTION

The arrangement under which most farm businesses operate changes over time. The family should re-examine its business arrangement as changes to laws and tax rules occur and family members enter or leave the business.

A sole proprietorship, partnership, joint venture or corporation are the possible forms of business arrangements that a farm business may adopt. No one form is right for every business nor should any business remain static throughout its lifetime. Every business needs to check the benefits of each arrangement to see which one best deals with the issues encountered by the business.

Many issues need to be examined before adopting a business arrangement. They include how the business will be owned and managed and the related legal, financial and taxation issues. Examine these issues and get a better understanding of the various business arrangements before discussing them with legal, financial, tax and other specialists.

DESCRIPTION OF THE DIFFERENT ARRANGEMENTS

The four types of business arrangements under which businesses operate are:

Sole Proprietorship
Partnership
Joint Venture
Corporation

Sole Proprietorship

A sole proprietorship is a form of business owned by one person. The business does not have a separate legal existence. It does not matter how many persons are working in the operation or whether they are family or non-family employees. The sole proprietor alone will collect the profits, pay the taxes, own the assets and incur any liabilities.

Joint Venture

A joint venture allows two or more individuals to maintain control over a specific business undertaking and contribute resources towards its accomplishment. However, they remain as separate entities otherwise. The owners may be separate individuals, partnerships or corporations who agree to work together and contribute some or all of their

assets, labor and/or management for use in the joint venture project.

The individual participants share only in the profits or losses of the activity undertaken in the joint venture project. They do not share in the profits, losses or risks of other business activities of the individuals.

The life of the joint venture project is limited to the time it takes to complete the project. The duration will vary, depending on the circumstances.

Partnership

In Alberta, the Partnership Act defines a partnership as "... the relationship that subsists between persons carrying on a business in common with a view to profit."

For business purposes, a partnership is a particular type of organization in which a number of individuals pool their resources to produce income that is shared by these individuals called partners.

This definition covers cases where two or more individuals have agreed, whether in writing or not, to become partners. It also includes any situation where the parties have behaved as partners, even if there is no formal agreement. Parties who do not want to be treated as a partnership for management, legal or tax reasons, should not operate as one. There is no legal distinction between the partnership and its partners.

A partnership unlike a sole proprietorship is a separate entity, distinct from the individual partners. In this respect, it is similar to the corporation because the individuals have agreed to form a common business and share in its results, rather than operating separately. From a taxation standpoint, a partnership is similar to the sole proprietorship. Income is distributed to the partners and they are taxed personally.

In the partnership, each partner owns a "partnership interest". This interest is usually related to the value of the capital invested in the partnership.

Not all assets must be transferred to the partnership. Some may remain with the individuals and be rented to the business. In the case of land, even if it is transferred to

the partnership, the title remains in the names of the individuals.

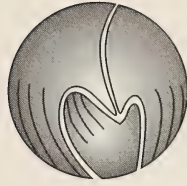
Corporation

A corporation is recognized as a separate legal entity (like a “person”) and is separate from the people who own it. Its assets and liabilities are its own; they do not belong to the people who created or own it. As a legal entity, the company is subject to the same laws and can do many of the same things a person can do. It may enter into contracts, sue or be sued in its own name, buy and sell property and carry on a business.

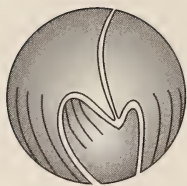
The public company is what most people think of when they hear the word “corporation”. Generally a public company is resident in Canada and has its shares listed on a prescribed Canadian stock exchange. Alberta Energy Company Ltd. and General Motors of Canada are examples. Either the words company or corporation can be used to describe this arrangement.

Farming corporations are almost always “private corporations”. A private corporation must be resident in Canada with fewer than 50 shareholders and must not advertise its shares for sale. To be considered as a Canadian controlled private corporation it must have one or more shareholders resident in Canada who collectively retain at least 50 per cent control.

When a corporation is formed, its owners, who are known as shareholders, may transfer assets (land, machinery, etc.) and possibly liabilities (debts) into the company in exchange for shares in the company. Shareholders own the company, and the company owns the title to the assets.



MANAGEMENT ISSUES



PROFITABLE, AFFORDABLE AND DESIRABLE

Before any business arrangement is considered, the family must decide if the business is profitable, if they can afford to proceed and whether everyone wants to enter into an arrangement. It is wise not to take any of the answers to these questions for granted.

The remainder of this publication assumes that the answers were yes to the questions about profitability, affordability and desirability, except for a few special considerations when the business is profitable and desirable but not affordable.



OPERATING THE BUSINESS

FARM BUSINESS CONTINUITY

A sole proprietorship lasts as long as the individual lives or continues the business as a sole proprietor. This can be an advantage, because the sole proprietorship offers a high degree of flexibility and allows an individual to make decisions as the sole owner of the business.

A joint venture, brings individuals together in a business enterprise only for the specific project they are operating. The joint venture will continue for the lifetime specified in the agreement, then it will be dissolved unless renewed. The advantage of the joint venture is that individuals can separate more easily when the agreement ends.

If the owners have a desire for the business to continue after any family members death, a corporation or partnership may be preferable. Both a corporation and a partnership have a perpetual existence and can exist as long as the owners want to keep them operating and the requirements of legislation are met. But remember the establishment of a partnership or corporation by itself is no guarantee that a farm business will continue from one generation to the next.

Because a corporation or partnership is a separate legal entity and can continue after the death of one or more of its owners, consider what should happen to the business after a death. Continuing the business may be a disadvantage to family members who own a minority share unless proper steps are taken to safeguard them.

COMMON BUSINESS OR SEPARATE

The decision to operate a business jointly with others should be made separately from that of which arrangement to operate under. There are many important and sometimes difficult questions to consider first.

When people cannot get along or work together, it is unlikely they will do so any better after they have signed a formal arrangement. The existence of a formal arrangement does not change the relations between family members. If, for instance, children do not work well together, no formal arrangements will ensure they will remain together after the parents leave the business.

Family members who value their independence may be better off to operate separate proprietorships rather than form a common business and risk potential conflict. In this way each person can control their own business while sharing work or machinery when it is in the common good.

A joint venture allows two separate families or persons to carry on some specific part of their operation together, while keeping other businesses or activities separate. If the arrangement causes difficulty or does not work, it can be dissolved with little or no effect on the other affairs of the individuals.

A business arrangement, whether a partnership, corporation or joint venture, does not relieve owners, managers and operators from working together with common goals and objectives. The interpersonal relationships of the people involved in the arrangement play an important part in its harmonious operation.

POOLING OF RESOURCES

An economic advantage may occur when labor, capital and management are pooled in an operation. This is particularly true when one family is just entering the business and has limited resources. A partnership, joint venture or corporation allows for this pooling of resources and may result in increased efficiency.

Within a partnership or corporation, the assets can be transferred to the business and be pooled in their use and ownership. With a joint venture, however, the assets are only pooled for their use and not their ownership. This has implications for the liability of individuals, tax considerations and ease of dissolution.

Effective management is required to make the best use of resources, no matter what business arrangement is chosen. If resources such as labor or equipment are not used effectively, forming a business arrangement will not change this.

OPERATING SPECIFIC ENTERPRISES

Individuals may consider forming a separate business to operate a specific enterprise such as a dairy or hog business. In this case, the livestock and possibly the buildings or specialized equipment may be transferred to a partnership or corporation.

The original owners of the assets must decide whether they wish to participate in the growth of this enterprise, retain only the original value of their assets or transfer some or all of the ownership to other individual. It may be that they intend to operate the specific enterprise jointly just long enough to allow the incoming member to gain experience before transferring it.

If a parent, for instance, wishes to get out of an enterprise and transfer it to a child, the assets may be transferred to a partnership or corporation. The parents may retain only sufficient value to maintain some control over the management.

When a specific enterprise is to be operated separately, it may be better to form a joint venture. This would enable two people to benefit from a joint enterprise while retaining their own businesses, unaffected by the new venture.



OWNING THE BUSINESS ASSETS

One of the major reasons farm families examine business arrangements is to properly arrange the ownership of business assets. While this is not the only reason to form a partnership or corporation, it is an important aspect.

ASSETS TO KEEP WITHIN THE BUSINESS

Before setting up any business arrangement, owners must decide which assets they will have to take out of the business for personal use when retiring or for passing to family members. The assets that are to remain in the business is a personal issue and one which must be dealt with separately from the decision of what business arrangement is required. In a family situation, parents should decide which assets they wish to leave in the business before they decide on the type of arrangement.

Transferring assets into a corporation or a partnership may appear to solve estate planning concerns but usually does not. Non-farming shareholders or partners may not want to own part of the business forever. They may prefer to exchange their shares or partnership interest for cash. Once assets have been transferred to a company or a partnership, it can be costly to remove them.

ASSETS TRANSFERRED TO THE BUSINESS

Sole Proprietorship

If the decision is to operate as sole proprietors, then the assets are owned by the individuals and will not need to be transferred to the business.

Operating two separate businesses may require the joint-use of some assets for several years. Working out specific machinery use or rental agreements is important for all parties. If a child has used the parents machinery to get established, then it may be fair for the parents to continue this arrangement for a number of years after the machinery has been transferred to the children. This allows the new generation to make the replacement decisions and pay for new assets. It also provides for the older generation's work to be done, but frees them from purchasing more equipment.

Joint Venture

When a joint venture is established, none of the assets of either party are transferred to the business. However, it is important to identify what assets will be made available for use by the joint venture. If compensation is to be paid to the other party when assets become unavailable, this must be clearly stated in the agreement.

Partnership

It is not essential to transfer all personal assets into a partnership. Some assets may be transferred into the partnership while others are retained by the original owners. Additional assets may be transferred to the partnership over time or to individuals instead. Valid reasons, tax or otherwise, may exist for assets such as land to be held in personal hands outside of the partnership.

The partnership must reach an agreement for the use of farm assets owned by non-farming children or others not directly involved with the operation, at a reasonable price.

The ownership of assets transferred into the partnership rests with the partnership even though the title remains registered in the individual(s) name. The ownership of the partnership is assigned to individuals through a partnership interest.

Corporation

As with a partnership, not all of the family assets should necessarily be transferred to the corporation. Some assets may be transferred into the corporation and others owned personally. There may be tax considerations or personal reasons for holding assets such as land outside of the corporation.

Farm assets transferred into the corporation are owned by the corporation. The ownership of the corporation is then divided by assigning shares to individuals. Different types and numbers of shares can be distributed to individuals. This has the potential to provide individuals with different amounts of ownership, protects minority shareholders, gives voting privileges to those who should have them and rewards those who have contributed assets, labor and/or management.

HOW THE BUSINESS IS OWNED

Partnerships are owned through a partnership interest and corporations through shares. However, the same questions must be asked when it comes to who should own the business. The first step is for families to outline the objectives of the business. Objectives of generating income and providing a living for several families may require different ownership arrangements than when the objective is solely to transfer assets to the next generation.

The percentage of a business owned by each individual may be based upon their contribution of capital, labor and management. If the distribution is to differ from this, then the partners who are willing to take less than their fair share must determine how it is to be divided. Because this is usually parents, they must decide what portion of the business ownership should be held by children and what portion they wish to retain. Both parents can be owners. The value of the business kept by parents will depend on their age, income and security requirements and level of involvement.

Growth In The Business

Parents must decide whether to continue their participation in the growth of the business or, because they have sufficient assets, see part or all of the growth go to the children. In a corporation this is done by specifying growth or non-growth shares. In a partnership, the participation in the growth of the business is specified by the value of the partnership interest. Be sure to check the tax implications of dividing business growth in proportions different from the individuals contributions.

Parents should carefully consider the decision to fix the value of their share of the business. They may require income and security for the remainder of their life, which includes protection against inflation.

Control Over The Business

Partners must decide who will control the business. In the case of parents, they must decide in advance how much control they want to keep and the amount they are willing to transfer to their children. Control is usually transferred over time rather than settling for all or no control.

In a partnership, control is exercised by the proportion of the partnership interest which each partner owns or as specified in the partnership agreement. In a company,

shares are designated as voting or non-voting, thus the control can be much more defined. The parents usually retain most of the voting power if the children are just starting in the business. As the children mature and get more involved in the business, more voting power will be transferred to them.

Often, control is distributed so that it takes more than one person to form a majority and make a decision. It must be remembered that those holding more than 50 per cent of the voting power hold the decision making power. Hopefully the ability to make sound decisions goes with it!

Ownership By Non-farming Persons

Non-farming children may be given or left an ownership in the business if there are insufficient personal assets outside of the farm for parents to leave to them. These non-farming children need to be involved in the management in order to protect their investment and ensure a reasonable profit. This may be seen by the active farming members as undue interference with the management and operation of the business. The management input and control by family members outside of the business however can have very beneficial effects on the management and thus the success of the family business.

Growth in the value of everyone's equity in the business should be expected over time. Often the person contributing the majority of the labor and management feels that the bulk of the growth should go to themselves. If they are being reasonably paid for their contribution of labor and management, then they should feel reasonably protected.

The feeling of lack of protection by the farming person usually arises in situations that are non-profitable or non-affordable. The person(s) farming know they will never be able to buy out the other members. Non-farming members will not leave their assets in this type of a business forever. This situation may be acceptable between parents and children because there may be reasonable assurance that the parents will not want out and on death the parents will bequeath their interest to them. This same outcome seldom occurs among the children.

Having a corporate structure may make it slightly easier to distribute the ownership and control of the business, but it will not solve the problem of which family members will participate in ownership. No business arrangement eliminates the need for a good sound discussion of the question of shared ownership and agreement on the ultimate transfer of control over the business.

HOUSING WITHIN THE BUSINESS

When land is transferred into a partnership or corporation, accompanying buildings are usually included in the transfer. This is desirable in the case of farm buildings, but may not be in the case of residences. Problems may arise when families do not “own their own home.” The benefit from the tax-free capital gains status of a principle residence no longer exists.

When the partnership or corporation owns the house, the occupants are considered to be tenants. This landlord-tenant relationship means that each must act accordingly. If major renovations are to be made to the house, it may be expected that the “tenants” will pay even though they don’t own the house. The occupants may also find it difficult to approach the management of the business (especially when they are relatives) to ask for necessary repairs. What one family thinks is necessary is often not considered essential by others.

TAXATION UNDER A BUSINESS ARRANGEMENT

Business income is taxed in the hands of an individual under a sole proprietorship, and that of the owners in the case of partnership and joint venture arrangements. The joint venture and partnership allows income to be distributed to a number of individuals, which may reduce the rate of tax and the amount paid.

The corporation however pays its own taxes. In fact, the most talked about benefit of a corporation is usually the flat tax rate of approximately 19 per cent on the first \$200,000 of taxable income. Qualifying small businesses are able to pay this rate rather than the progressive rate paid by individuals.

If the number of people involved in the business allows for tax reduction below 19 per cent through income splitting, then a corporation may not save taxes. Tax savings can be used within the company for increased growth or be paid out through dividends or other means. Carefully examine this issue, since with “husband-wife” partnerships and multi-family involvement, it may be possible to split the income and operate at a lower rate of income tax without a corporation.

Generally, if each person actively involved in the operation has a taxable income greater than \$30,000 annually, there may be benefits to incorporation.

COST OF ESTABLISHING THE ARRANGEMENT

All business arrangement should be set up properly. This ensures everyone understands what the agreement says and what is expected of them and others.

Writing the partnership, corporation or joint venture agreement will require the services of a lawyer and accountant to ensure that arrangement is legal and does not attract undue taxation. The yearly preparation of accurate and proper records will also greatly increase everyone’s understanding and improve communications.

Incorporation involves legal requirements that the other forms of business arrangements do not. A corporation has to file financial statements and annual reports with the companies branch of the Alberta Government. The corporation must also file its own separate tax return, thus additional accounting and legal costs will be incurred.

The transfer of property to the partnership or corporation will also involve legal and accounting fees. The cost of special arrangements such as shareholders and partnership agreements and deferred profit sharing plans should be discussed before drawing up the formal arrangements.



LEGAL ISSUES



CAPITAL STRUCTURE

The capital structure of any business arrangement refers to how its assets are held by the owners. When the arrangement is created, the owners must decide how they want to own the business.

WHO OWNS THE FARM ASSETS

The family needs to decide whether they wish to own the farm assets in their own names or are satisfied with the business owning the assets and they in turn own the business. While there may be several formal reasons why one or the other will be best, the family must decide.

If the family keeps the assets in their individual names, then a sole proprietorship or joint venture will work. As well, a form of operating partnership or corporation in which the assets are kept in the owners names and rented or leased to the business may work. The following discussion examines the ownership structure for each of the business arrangements.

Sole Proprietorship

In this form of business, the individuals retain ownership of their assets. They may own the assets individually or jointly with others even though they are the only ones who own, manage and operate the business. There are numerous cases of the person who is farming adding someone else's name to the title. For example, a spouse or child may be added for estate reasons, even though they are not involved in the business.

Joint Venture

Because a joint venture does not own assets, the assets remain in the names of the original owners even after the joint venture agreement is set up.

Partnership Or Corporation

When it is decided that the partnership or corporation should own the assets, they are legally transferred to the business. With a corporation, the actual titles to land will be transferred to the corporation, while in a partnership the land title remains in the name of the original owners and assets are held in trust by the original owner(s) or a

designated trustee. The titles to machinery or equipment will be transferred to the partnership or corporation.

Sold To The Business – In exchange for assets, the original owners may receive payment in cash, the same as if they were being sold to anyone else. If the partnership or corporation does not have sufficient cash or the owner does not need the cash, a loan or mortgage may be taken. This is referred to as a partnership or shareholders loan. Tax considerations should be examined.

Partnership Interest – In exchange for the transfer of the assets to a partnership, the original owner may receive a “partnership interest”. This is a percentage ownership of the partnership. This “partnership interest” can then be sold or given to others much the same as the original assets were.

Shares – When assets are transferred to a corporation, the original owners may be issued certificates in the corporation called “shares”. These shares represent a percentage ownership in the business and can be sold or gifted much the same as the assets. There are different types of shares known as “classes” each with their own legal characteristics and specifications. For convenience, shares are often referred to by the names, *common* and *preferred*.

Specific reference to common and preferred shares has been removed from the Alberta Business Corporation Act (ABCA). However, these general descriptions of shares are still in use and can be helpful in distinguishing shares with different characteristics from one another.

GROWTH IN THE BUSINESS

A “common” share changes in value as the value of the corporation changes. Its value depends totally on the value of the equity in the corporation. If the business does well and its value increases due to profits and/or inflation, then the value of the common shares increase.

In small or closely held corporations, such as farms, there are usually strict limitations on the sale of the common shares. Agreements will be put in place that detail who can buy and sell shares and under what conditions sales

are allowed. This may mean that the “value” of shares is really only a book value and may differ significantly from what it would be if publicly traded.

The interests in a partnership represents its value and changes with the growth of the business. The share of this growth going to each partner depends on the percentage of partnership interest they have.

FIXED BUSINESS VALUE

A “preferred” share will usually have a specified value. Its value will be set at a certain dollar value and will have a specified dividend rate. The value remains fixed, unless the company does so badly that the asset value falls below the total value of these shares.

A partnership has no mechanism for setting a fixed value like the corporation does. As the value of the business changes, so does the value of the partnership interest.

Preferred shares often have the following characteristics:

- priority for pay-out over common shares in the event of the corporation being dissolved
- a fixed dividend rate or the possibility to participate in profits
- priority over dividends paid to common shares or the possibility to accumulate dividends when unpaid. (cumulative vs. non-cumulative)
- be subject to repurchase at the request of the shareholder and/or the corporation under limited conditions (redeemable and retractable).
- participate in the income and asset growth if specified.
- right to be converted to common shares.

VOTING RIGHTS

Any class of shares can be given the right to vote. It need not be limited to only one particular class. Anyone with the right to vote has a say in the control of the business. They elect the directors who hire the management and thus determine the direction of the company. Shareholders holding non-voting shares do not have voting rights except as provided for under the articles of incorporation.

The partners of a business all have the right to participate in the management of the business. The agreement should specify how decisions will be made and whether anyone is given more power than anyone else.

ASSETS RENTED OR LEASED TO THE BUSINESS

A partnership or corporation may be formed and not all of the assets transferred to it. It may be advisable to keep some or all of the land or other assets in the names of the original owners and rent them to the company. It is important to ensure that this type of agreement results in a business arrangement which provides appropriate benefits without undue tax, accounting or other complications.



RIGHTS AND OBLIGATIONS OF BUSINESS OWNERS

DECISION MAKING

The potential for conflict exists when a business has more than one owner, and with it the potential for detrimental financial and business results to any member. The decision of the majority will generally prevail. Without specified rights, there would be nothing any individual member could do to prevent the majority from doing things that may not be in the best interest of the business or an individual member.

This is not a concern in a sole proprietorship, because each person manages their own business. This may be a good reason for families to help children set up their own separate business rather than working together. If however family members want to operate together, then agreement over the decision making process is needed.

Board Of Directors

While a board of directors is a legal requirement for corporations, directors perform an important role in any business. Establishing a board enables the owners to know who is in charge, how decisions will be made and how to incorporate input from knowledgeable outside sources.

A board is responsible for setting general policy and direction for the business. It decides on the type of operations to be carried on and any payments made to the owners. It names the management, which may be one person, a number of co-managers or the board may reserve the job of management for itself. In this way the owners, through the board, direct the overall functioning of the business.

Protection For Minority Owners

Certain procedures and policies can be embodied in an agreement to provide minority owners protection while allowing the majority owners to carry on business without undue interference. The method of doing this varies depending on whether it is a partnership, joint venture or corporation.

Corporate Agreements

The shareholders agreement may include specifications of the rights of both majority and minority shareholders.

Minority protection does exist through the courts. If a minority shareholder has been treated unfairly, the courts

LIABILITY WITHIN THE BUSINESS

have the authority to make orders to correct such unfairness under the Alberta Business Corporation Act.

The Alberta Business Corporations Act also affects the rights of share holders.

Partnership Agreements

Partnership agreements can contain certain procedures and policies, such as limits on the cheques any one partner can sign, which would provide individual partners protection while allowing the partnership to carry on business without undue interference.

Joint Ventures

It is important to specify in a joint venture how decisions will be made and who has the authority to make them. The agreement should be structured so that all participants in the joint venture are involved in specifying the general direction and intent. Specific individuals can be identified to manage the day-to-day operation.

The question of liability is important in any business when the actions of one person have implications for others members of the business.

It is possible to limit the amount of liability, that any one member of a partnership or corporation has, to the amount each member has invested in the business. This is permitted by either a limited partnership or company. Limited liability may not be very important to persons transferring all of their assets into the business.

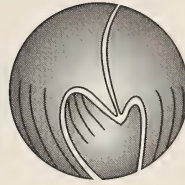
Limited partnerships only limit the liability of an owner who is not actively engaged in the management or operation of the business. It does not apply to the general partners, but may be useful for non-farm children who want to invest in the business.

Any time one of the owners guarantees a loan, this limited liability is over ridden by the guarantee.

Joint ventures provide for limited liability because the owners have not pooled all of their assets in the joint venture project. Each joint venturer is liable only for what they have in the project. It is important that a joint venture not operate as a partnership if they want to be ensured of this limited liability.

Specifically, each and every partner becomes personally responsible for the debts and liabilities of the partnership as well as wrongful business acts of the partners. The Partnership Act (Alberta) states that "Each partner in a firm is liable jointly with the other partners for the debts and obligations of the firm incurred while he is a partner." He/she is also liable for a "...wrongful act or omission of a partner acting in the ordinary course of the business of the firm..."

In a corporation the directors are liable for the wages of employees and the employer premiums for CPP and UIC. Directors are also responsible for other forms of liability such as environmental liability. This is a complex area and should be checked carefully with a lawyer.



FINANCIAL ISSUES



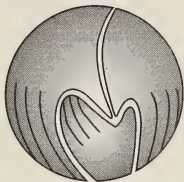
INVESTMENTS IN THE BUSINESS

Assets Transferred To The Business

The family must decide which assets will be transferred into the business. The decision may be based on the type of business or other factors such as legal and tax considerations.

Land Kept Out

Land is often kept out of the business arrangement for reasons which may include: later distribution to individual farming or non-farming children; long-term security of the parents; or the negative tax treatment of capital gains, especially in a corporation. The removal of land from a corporation or partnership is done at fair market value. There are special methods, which require the advice of a lawyer, for minimizing the tax payable when removing assets.



FINANCING WITHIN THE BUSINESS

The two forms of financing are debt and equity financing. The acquisition of debt or equity financing is a major issue for most businesses no matter what type of arrangement they have. Equity financing by definition means people are bringing their equity into the business. This form of financing is common in farming, but usually only with family members. The various forms of business arrangements have little effect on this type of financing.

EQUITY FINANCING

Equity financing is money that is contributed to a business from its owners. This is usually from family members involved in the business, but may also include investors from within or outside the family. Forming a corporation is the best way to facilitate equity financing. Since outside equity is seldom used, the type of business arrangement will have little effect on most farm businesses.

The reason for a lack of outside investment in agriculture lies in the difficulty of formalizing arrangements and relationships. In many family businesses a fundamental conflict exists between what is most profitable for the business and what the manager and/or operators want to do.

While the manager is supposed to manage and operate the business in the best interest of the owners, there is often an element of personal pride or enjoyment involved. For example the building of an extensive shop or purchase of machinery or vehicles, while for use by the business, is influenced by their enjoyment value to the operator.

The requirements that non-business shareholders may specify in the way of controls, such as full audits, might be too costly or not acceptable to the farming persons.

Even though agreements and controls are possible through shareholders or partnership agreements, the fact family businesses have few outside investors indicates that it is probably too cumbersome or expensive to allow it to happen.

DEBT FINANCING

Debt financing is the money a business borrows from outside sources. These sources do not have an ownership in the business. Corporations, partnerships or joint ventures all face the same benefits and risks when borrowing money. The limits on the debt a business can carry are determined by the ability of the business to generate income and the value of the assets it pledges for security. The formation of any specific type of business arrangement is unlikely to affect the availability of borrowed money for the business.

Operating Loans

These loans, which are due within the year, are acquired by the business in the same manner, no matter what the business arrangement. Major shareholders, partners or joint venturers are usually asked to sign personal guarantees if the loans are of a significant size.

Term Loans

Loans with repayment terms longer than one year may be secured by individual assets, all of the assets of the business or personal guarantees.

Individual Business Assets – No matter what the form of arrangement, the assets purchased by the business with borrowed funds may be taken as security. In the case of default, the lender will take steps to realize on the security according to the terms of the loan agreement.

All Of The Assets Of The Business – Debts may be secured by the total assets of a business in a corporation by the lender taking what is known as a “floating debenture” as security. This gives them all of the corporations assets as security. In the case of default, they may, depending on the contract, seize the entire assets of the company. This may leave the shares of the company worthless.

The lender will use the “Personal Property Security Act” (PPSA) to secure the loan against all of the business assets that can be secured under the act.

Personal Guarantees

Individual owners will often be asked to guarantee the loan. In case of default, the individuals will be forced to cover the shortfall from personal assets if the seizure of the asset does not cover the repayment of the loan and related seizure costs.

It is unusual for a lender to take shares or partnership interests as security, because in private family businesses they are difficult to liquidate and therefore of little or no value to the lender.

Family Debt

Debt is often a valuable control over the management of a business because the use of debt not only allows lenders to analyze the proposed investments, but forces the management of the business to ensure business assets perform at least well enough to meet loan repayment obligations. Profitable businesses will be able to make their debt payments and still provide a reasonable return on equity.

It may be advisable for non-farming children or parents to loan money to the business rather than take ownership. Parents may do this by taking loans when forming the business or by transferring shares or a partnership interest to the farming child(ren), with mortgages placed against such shares or interests. These mortgages can be willed or given to the non-farming children. In this way, the farming children will have little or no interference in operating the business as long as they make the debt payments. If the business is allowed to weaken and debts go into arrears, then the non-farming children can exercise some control to enforce tighter management or remove management entirely.

It may be difficult for parents or off-farm children who wish to take their money out of the farm to do so. These issues should be considered before any arrangement is finalized.



FINANCIAL CONTROL WITHIN THE BUSINESS

PROFIT AND LOSSES WITHIN THE BUSINESS

Owners must decide if they want the profits and losses of the business to accumulate within the business itself or go to the individual owners.

Under a corporate structure, profits and losses from farming accumulate within the company rather than in the hands of the individual owners. There is one set of books into which all revenues and expenses are entered. Revenues are deposited into a corporate bank account and expenses are paid out of this account. The bank account is the property of the corporation and in its name. The account will identify who is eligible to deposit money and write cheques.

With a sole proprietorship, joint venture or partnership, the revenues and expenses should be run through one business bank account and at the end of the business year the profits or losses allocated to the individual owners. This does not mean the profits are all withdrawn. What it does mean is that profits are credited to and taxed in the individuals hands.

At the end of each fiscal year, a complete set of financial statements should be produced showing the financial situation of the business, no matter what the business arrangement. The statement will indicate the profit or loss, as well as any other financial information useful to the owners.

MONEY TAKEN OUT OF THE BUSINESS

In a sole proprietorship, all of the income and money belongs to the individual and he or she has only to withdraw it from the bank account.

With a joint venture, the revenues and expenses are allocated to the individual joint venturers. There must be some agreement, however, within the joint venture to dictate how much of this profit will be made available to the project and how much can be taken by the joint venturers.

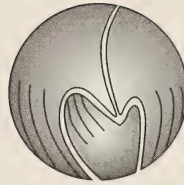
With a partnership or corporation, the revenues and expenses are not allocated to the individual owners. The profits or losses accrue to the business and accumulate within it. The owners must decide how much of this profit

can be paid out to each individual and when. The procedures for making payments differ for a partnership and a corporation.

Under a corporation, profits or losses of the business belong to the company. For the owners of the business to obtain money from the company, the money must be paid as salaries, management fees, directors fees, dividends, repayment of shareholders loans or as loans to the shareholders. There are some interesting taxation strategies which come into play to determine the appropriate form.

Under a partnership, profits or losses of the business belong to the partners. However, profits are not always in the form of cash that can be withdrawn. To obtain money from the business, partners must take withdrawals or repayments of loans. Unlike a corporation, salaries are restricted to non-owners in a partnership.

The amount and timing of money withdrawn by an owner should be determined at the beginning of each year, no matter what form of arrangement. This withdrawal should be paid out of the business account and put into the owners' personal account. Owners should not use the business account for personal transactions or for other businesses.



TAXATION ISSUES

The tax advantages of various forms of business arrangements are often emphasized. But they must not be considered in isolation from the management, legal and financial considerations involved in choosing a business arrangement.

One of the most important issues in taxation of business arrangements is the fact that individual owners pay taxes on income under sole proprietorships, joint ventures and partnerships; however, the business pays the taxes on income within a corporation. A corporation has its own special tax rates for active business income and its own set of rules and rates for capital gains. Everyone needs to examine their particular situation in detail before making a decision.

This section will acquaint the reader with some of the basic terminology and concepts used in business tax planning and should not replace professional advice.



TAXATION OF INCOME

ACTIVE BUSINESS INCOME

Active business income includes income from farming but excludes income from capital gains, dividends, interest, investments, rentals or royalties.

Sole proprietorships, joint ventures and partnerships do not file an income tax return and are not subject to income tax. The income is distributed to the owner or owners and they file personal tax returns which include business income and other income. A partnership however acts like an individual by calculating its taxable business income then allocating it to each partner. In effect, while taxable income is determined at the partnership level, it is the individual partners who are taxed.

A corporation is a separate legal entity that pays its own taxes at corporate tax rates. Active business income within a corporation in Alberta is taxed at a rate of 44 per cent. If the corporation is a Canadian controlled private corporation and qualifies for the small business deduction, its blended federal and provincial income tax rate will be reduced to about 19 per cent. Both the 44 per cent and 19 per cent rate are flat rates unlike the progressive rate for private individuals. Most farming corporations qualify for the lower rate of tax.

If a business is very profitable and finds itself with a high tax rate, it may be advantageous to consider forming a corporation in order to reduce taxes and retain more money within the business.

Capital Cost Allowance

Under a corporate structure, any assets owned by the corporation are depreciated in the corporation before the tax is calculated.

With a partnership, capital cost allowance (CCA) is taken in the partnership before the income is allocated to the individuals. This restricts the individual owners from electing separate amounts of CCA. Assets that are owned by the partners, outside of the partnership, will have CCA taken by each individual, independent of the other partners.

With sole proprietorships or joint ventures, the assets are held by the individuals. The income from the business is allocated to the individual and then they are free to take whatever CCA they wish, independent from each other.

This difference in handling CCA may be important when deciding on which business arrangement to adopt.

Taxation Of Salaries

A corporation is the only type of business arrangement able to pay salaries to its owners. Sole proprietorships, joint ventures and partnerships cannot pay salaries to owners. They transfer money to their owners mainly as withdrawals.

Money received by owners or other individuals as salaries from a corporation is taxed as employment income in the hands of the employee. The regular deductions for Canada Pension Plan (CPP) and Unemployment Insurance (UIC) will also apply. However, shareholders who own more than 40 per cent of the voting shares in the company and who are also employees are exempt from UIC premiums.

Taxation Of Dividends

Only corporations can pay money to owners as dividends. The tax treatment of dividends in the hands of the recipients differs from other forms of income. In addition, there are several types of dividends, most of which attract income tax liability. For income tax purposes, a "dividend" can generally be taken to mean the distribution of a share of the after-tax profits of a corporation to its shareholders. While dividends are taxed in the hands of the recipients they also generate a special dividend tax credit. This effectively reduces the tax that the recipient pays on dividend income and makes them more attractive from a taxation standpoint.

INVESTMENT INCOME

Investment income includes interest, the taxable 75 per cent portion of capital gains, rental payments and royalties. This income is also taxed within a corporation but in the hands of the individuals for the other business arrangements.

Note: Investment income in a corporation is *not eligible* for the small business deduction and is taxed at the higher combined federal/provincial rate of 44 per cent in Alberta. This applies to all investment income generated by the corporation.

Capital Gains

The taxation of capital gains can be significant for most businesses. A basic understanding of the rules surrounding the taxation of capital gains will help in the planning of business arrangements and property transfers. Competent professional advice should be obtained to discuss detailed tax implications before embarking on any course of action.

Capital gains arise when capital assets are sold or deemed to be sold for more than their Valuation Day value or their purchase price if bought after 1971. Capital assets include property such as farmland, buildings, machinery, quota, partnership interests and corporate shares owned by an individual.

For example, if land was purchased in 1973 for \$20,000, this becomes the corporation's "cost base" of the property. When the property is later sold for \$120,000, the capital gains is the difference between the cost base and the proceeds from disposition, which in this example is \$100,000.

Capital gains can arise through a number of different situations, some of which are planned and some not. Revenue Canada for instance, may deem assets to be sold on the death an individual. This deemed disposition results in the disposal of all of his or her property just prior to death. Other examples include mortgage foreclosures, property seizures by creditors or the ceasing of Canadian residency. Because of these issues, it is important to understand how capital gains are handled in each of the business arrangements.

Corporations

Capital gains on shares in a farming corporation occur when the value of the shares increase from the original value established when the corporation was set up or its Dec 31, 1971 value, if the corporation was in operation before that time.

The \$500,000 capital gains exemption is not available to corporations and the regular corporate tax rate of 44 per cent is applied to the taxable portion of capital gains. Capital gains on shares in a farm corporation sold or transferred by the owners qualify for the capital gains

exemption provided that the shares are “qualified farm property”. Shareholders themselves are limited by the \$500,000 lifetime capital gains deduction.

(Because the government is considering changes to the lifetime exemption, professional advice should be gained before any agreement is entered into).

Partnerships

With regard to capital property, any capital gain or loss resulting from the disposition of a capital property owned by a partnership is allocated to each partner on the basis of his/her partnership interest. Each partner then treats the capital gain or loss as if he/she had realized it separate from the partnership.

Investment Income Paid Out

If a sole proprietorship, partnership or joint venture receives investment income, as described above, it is allocate, but not necessarily paid out, to the owners and taxed in their hands.

If investment income is generated within a corporation, there are special tax rules that allow the tax rate to be reduced below what the individual would have to pay when paying it out as a taxable dividend or tax free capital dividend.

Capital Dividends – Capital dividends are the distribution of the non-tax portion of investment income resulting from rental income, royalties, capital gains, etc and are tax free to shareholders.

Taxable Dividends – Taxable dividends are the distribution of the taxable portion of investment income resulting from rental income, royalties, capital gains, etc. Owners receive a tax refund equal to 20 per cent of the investment income to a maximum of 25 per cent of the taxable dividends declared. This refund is called a refundable dividend tax credit and may be an important means of reducing taxes for businesses with significant amounts of investment income.



TAXATION OF ASSETS TRANSFERRED INTO THE BUSINESS

The owners and managers of partnerships and corporations need to be aware of taxes on transferring assets into the business, since some or all of the individual owners' assets may be transferred to the business. The tax rules are similar for both the partnership and the corporation.

The general rule for the transfer of property to a business states that the transfer must take place at the fair market value of the property. This may result in capital gains on the transfer of non-depreciable capital assets such as land, recaptured capital cost allowance and/or capital gains on depreciable assets such as machinery, and income from the transfer of inventory such as livestock or grain.

The Income Tax Act allows owners to elect an amount less than fair market value for the transfer price when transferring to a partnership or corporation. This election is a deferral of income tax when property is transferred. The types of property considered "eligible property" for this election are:

- capital property including depreciable property (such as machinery, land and buildings) other than real property owned by a non-resident;
- accounts receivable;
- eligible capital property (such as quotas);
- inventory (such as livestock, feed and seed);
- a NISA fund.

Note: To trigger a capital gain, a transfer price may be selected anywhere between the tax value of the asset and its fair market value. This may be a wise strategy to exploit any capital gains exemption, to use reserve rules or as part of a broader management strategy. Professional advice is essential for making the best choices.

TRANSFERRING PRINCIPLE RESIDENCE

Be careful when considering the transfer of a principal residence to a partnership or corporation. The owners lose control over their house in this situation, because it is now owned by the business and its owners. Occupants of the

house are considered renters and may have to obtain the approval of the business owners before making renovations.

An individual's principal residence exemption cannot be transferred to a corporation or partnership. By creating a legal subdivision, the parcel could remain in the individual's hands and not be transferred to the business. This would retain the principal residence exemption for the owner.

A house and one acre can be transferred into the partnership or corporation at fair market value, with no tax to the individual by using the principal residence exemption. In this way, the corporation takes the residence over at the market value and any future gain will be taxed in the company.

Expenses such as mortgage interest, property taxes and some Capital Cost Allowance (CCA) are tax deductible for companies owning houses. To justify these expenses and to avoid taxable benefits to the occupants, a reasonable rent should be charged by the company.

TRANSFERRING LIABILITIES INTO THE BUSINESS

Some or all of an individual's debt can be transferred to a partnership or corporation. When debt is transferred, the partnership interest or shares of that individual may be reduced accordingly. Or, in the case of one owner, a reduction in the value of their shares or partnership interest will result.

When the debts assumed by the business are greater than the Adjusted Cost Base (ACB) of an asset, capital gains are triggered. When the debt is greater than the Undepreciated Capital Cost (UCC) of the depreciable capital assets transferred, recaptured CCA occurs. Transferring debt on inventory results in taxable income. Because this is a complex subject, professional advice should be obtained before transferring debt to a corporation or a partnership.



TAXATION OF FAMILY MEMBERS WHO ARE ACTIVE IN A BUSINESS

There are a number of issues to consider when examining the forms of business arrangements in relation to splitting tax with the owners' family. A few of these will be mentioned here although sound professional advice is required before any actions are taken.

A SPOUSE OR CHILDREN AS EMPLOYEES

Any remuneration paid to an employee, who is also the spouse of a partner or shareholder, will be fully deductible to the business. No portion of the income will be allocated back to the partner. Spouses and children's salaries must be comparable to what would be paid to non-related arms-length employees and are taxed in their hands.

The business pays the employers share of CPP premiums for the spouse and CPP and UIC for children who are over 18 years of age.

SPOUSE AND CHILDREN IN THE BUSINESS

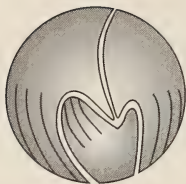
Husband And Wife Partnership – It is often difficult to provide proof of the existence of a husband-wife partnership that satisfies Revenue Canada. To ease the burden of proving the legitimacy of the partnership to Revenue Canada, a couple should first set up a formal written partnership agreement outlining the capital, management and labor each will contribute. Second, they should maintain separate bank accounts and financial records and establish each one's contribution. Third, they should file separate tax returns, even if the business experiences a loss. There are other major elements that Revenue Canada may look for in a valid husband and wife partnership.

Family Partnership – Family members can be given a partnership interest in the business. While this will split income and possibly reduce taxes, all of the other considerations of including children in the business should be carefully examined.

Corporation – It is possible to issue shares of a corporation to a spouse and/or children. The company can pay salaries to the family members or distribute after tax profits to these shareholders as dividends. Tax on dividend income

from these shares will not be attributed back to the parents or spouse who originally owned the business.

Involving family members as partners or shareholders, especially if it is just to split income, should be carefully considered. The ability of the original owners to deal effectively with the business may be reduced. Shareholders agreements, retractable shares and partnership agreements should be used to safeguard against disputes and undue interference in the business by minority owners.



GOODS AND SERVICES TAX

The requirement to collect GST does not differ between the various business arrangements. Items that are exempt or zero-rated for one form are handled the same for all forms.

On the transfer of real property (land and buildings) into a partnership or corporation, the individual is not required to collect GST on the transfer if the partnership or corporation is registered prior to the date of the transfer. The business shows the tax payable on Form GST60 which it files with its Input Tax Credit (ITC) claim.

If more than 90 per cent of the assets of the farming business are being transferred, an option is available which eliminates the farmer's requirement to collect GST. This option requires that both the vendor and the purchaser be registered prior to the date of the transfer. Under current law, a joint election must be filed with Revenue Canada, Customs and Excise. Recent draft legislation removed the election requirement and replaces it with an obligation for the supplier to notify Revenue Canada of the transfer.

The GST is another factor that should be reviewed with professional advisors before entering into any business arrangement.



CONCLUSION

This book has presented many of the general concepts and facts about the various farm business arrangements. It will not make the reader an expert in the field, but has endeavored to prepare them to more competently approach tax and legal specialists for advice.

The decision to form a joint venture, partnership or corporation is an important one that requires good deal of thought and planning. It is unlikely that any of the business arrangements can solve all of your problems and concerns. If one appears to provide sufficient benefits with minimal future risks, then it is worth seeking professional advice.

Sound advice before, during and after establishing an arrangement will be required to help ensure the maximum benefits for everyone involved.



